



**COUNCILMEMBER DONNA FRYE**  
**City of San Diego**  
**Sixth District**  
**MEMORANDUM**

**DATE:** April 30, 2007

**TO:** Honorable Mayor, City Attorney and Councilmembers

**FROM:** Councilmember Donna Frye *Donna Frye*

**SUBJECT:** 2003 Comprehensive Annual Financial Report

A week from today, on May 7, the Council will be asked to "receive" the City's FY 2003 CAFR. This is an unusual event, and indeed the first time the Council will be asked to "receive" an audited Comprehensive Annual Financial Report (CAFR) on the City's official financial condition for a given period.

Previously, the City Manager would informally provide Council members with courtesy copies of the CAFR. In any event, the Council was not required, or even asked, to "receive," "accept" or in any other way exercise a possessory interest in the contents of the CAFR. That made sense because this was always "management's" work product and the City Manager performed the management role.

After the passage of the "strong mayor" form of government, the Mayor's office succeeded to the "management" role previously exercised by the City Manager. At the same time, lessons were being learned about the consequences of participating in any material respect in the compilation of financial information, which was less than completely accurate or truthful. Many of our prior senior management are no longer with the City as a result of their participation in the presentation of financial information to the public and capital markets which, in retrospect, must be seen as creative at best.

The consequences of this less than completely accurate approach to financial matters spilled over onto councilmembers with very unpleasant consequences we are just now trying to put behind us. Therefore, it is appropriate that the Council act deliberately and cautiously regarding this new 'process' which shares, if not transfers altogether, the legal consequences of the public issuance of city financial information, the compilation of which is under the exclusive control of the Mayor's office.

## Why “Receive” the CAFR?

Currently, the Municipal Code does not require the City Council to “approve” or “receive” any CAFR. That makes sense, since the City Council does not have access to the underlying source information. In fact, under our new form of government, all employees involved in the preparation of the CAFR are under the management of the Mayor, and are not directly available to councilmembers for the direct sourcing of information or the answering of questions.

When we see CAFRs, and similar materials, it is at the end of a long management compilation process. Vetting and verification has occurred elsewhere. Members of the general public have much the same basis as councilmembers for opining in any respect on the adequacy, accuracy, completeness, etc of the numbers presented to us, usually by the Mayor’s CFO.

If we “receive” these financial materials, we do so as the representation of the City’s financial condition as compiled, and attested to, by the Mayor’s office, not by our offices.

This is an important issue to remember because this first- ever, official “receipt” process is scheduled for next Monday. As part of such proposal by the Mayor, I would appreciate knowing from the Mayor and City Attorney why, exactly, our “receipt” is required. What is the legal and practical significance of voting to “receive” these materials? In addition, what responsibility, if any, would or could come to the Council, or its individual members, as a result of agreeing to just ‘receive’ this CAFR? I would also appreciate having the same questions responded to regarding the “accepting” of the CAFR. Is “receiving” the CAFR different than “accepting” the CAFR?

Assuming those answers are forthcoming, and acceptable to the City Council, I believe that the Council will want to correctly define and limit the scope of the action we will be asked to take.

While the Council may be willing to participate in the proposed new process of “receiving” CAFRs, it is likely that the Council would want to “receive” such materials with the clear understanding that these are the Mayor’s financial materials and representations to the public and the capital markets. The Council’s formal “receipt” should define the very limited role of Council involvement in the review of these materials, and non-existent involvement in the compilation of these materials.

Such a position is the only way to both preclude any future misunderstandings of any compilation or independent review responsibility of the Council, as occurred in the past, and to acknowledge the clear authority of the Mayor’s office on such items under our new form of government. The CAFRs are the Mayor’s presentation of the financial condition of the City.

Therefore, on this issue alone, I think all members of the Council would appreciate receiving from the City Attorney’s office *by Wednesday, May 2* the proposed language of

the Resolution and specific action the Council will be asked to vote on next Monday, May 7. This should not be a problem since the “receiving and filing” of the 2003 CAFR had been docketed previously for March 23, 2007.

### **Need for Amended Certificates from the Office of the Mayor and the Disclosure Practices Working Group**

I have prepared and attached a timeline of events related to the issuance of certain City financial materials relevant to the action which will be considered by the Council next Monday. I believe the timeline will be helpful for the Council as a review in preparation for “receiving” the CAFR.

I will start with what I think needs to happen before next Monday. It should be easy to accomplish. I will also provide why I think we must ensure the inclusion of the KPMG Internal Control Report in the 2003 CAFR.

The Certifications from Mr. Goldstone and Mr. Levin on their own behalf, and on behalf of the Mayor, and from Mr. Blake on behalf of the City Attorney and the Disclosure Practices Working Group need to be re-issued specifically referencing the KPMG Internal Control Report dated March 12, 2007 (but not actually released until March 22, 2007).

In addition, the Letter of Transmittal language on pages 19 and 20 (OTHER FINANCIAL INFORMATION) should be amended to more accurately reflect the:

- findings of the KPMG Internal Control Report
- City Auditor’s January 1, 2007 Internal Controls Report
- IBA’s January 25, 2007 Report Number 07-18

I think the Council will find this a required condition to the action requested next Monday for the following reason: On March 16, 2007, KPMG released its “clean” (unqualified) audit Opinion Letter for the 2003 CAFR. It was only after the announcement of the “clean” Opinion Letter, that I learned that KPMG *later* issued a somewhat devastating Internal Control Report, which was intended by KPMG to be read *concurrent with* its Opinion Letter, previously released to the public with much fanfare.

Specifically, KPMG’s Opinion Letter states that the Internal Control Report “**is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.**”

KPMG’s Internal Control Report basically suggests that the existing internal controls of the city are inadequate to “detect within a timely period...errors or fraud in amounts that would be material in relation to the financial statements...”

It recommends that material revisions to the City’s internal controls for financial reporting be immediately implemented along with certain Kroll recommendations.

The Mayor's office has stated that it will move forward with some of the Kroll recommendations, but recommends delaying Kroll remediation #36, which specifically recommends an audit for the present period (2007-2008) of the City's internal control processes for financial reporting. Last week, the Mayor's CFO, Mr. Goldstone, recommended that the City postpone this audit until after the new computer system was installed, which appears to be June 2009 at the earliest.

And, of course, many of the internal audit division staff are working on the financial reports and there is currently no Internal Auditor for the city (the possible circumstances of the last City Auditor "retiring" in January 2007 is also found on the timeline).

With all that in mind, the first problem for next Monday are the "Certifications" to the Council received from the Mayor's office and the Disclosure Practices Working Group were acted upon and signed *before* the release of KPMG's **Internal Control Report**. They may have known it was coming, or not. It does not matter. The point here is that while the Council is being asked to act on the proposed 2003 CAFR based upon *all* information available as of next Monday, the certificates of assurances of the Mayor and the DPWG were acted on *before* the KPMG **Internal Control Report** was released.

We will need them reissued now, so we can be certain that the Certifications of the Mayor, CFO and the City Attorney's DPWG feel comfortable with their unconditional support for the Council's "receiving" of these materials, for whatever purposes the Mayor's office has in mind for them, fully cognizant of all the implications of KPMG's Internal Control Report and any other information from KPMG such as the SAS 61 Report.

I am confident that no member of the Council would want financial information to be available to the public or capital markets that does not specifically incorporate this very important KPMG Internal Control Report. Additionally, I believe it is important for the Mayor's office and the Disclosure Practices Working Group, in assuring the Council of the adequacy and accuracy of the materials to specifically incorporate the KPMG Internal Control Report by specific reference.

These amended certifications specifically incorporating KPMG's Internal Control Report and changes to the Letter of Transmittal should easily be available to us by next Monday, or before Council is asked to take any action.

## Brief Timeline for 2003 CAFR

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**October 2, 2006** –Mayor Jerry Sanders issues a Memorandum to City Council with the FY 2003 Draft CAFR (eighth unaudited draft) attached. The City Council meeting to “review, comment and approve for use the FY 2003 CAFR” is scheduled for October 16, 2006. Mayor also releases a Fact Sheet on the FY '03 City Financial Statement.

The Mayor’s Fact Sheet notes that the 2003 unaudited CAFR **“includes the re-statement of 57 different line items (recalculations of debt, value of capital assets, energy expenses, claims against the City) that were previously improperly classified or stated. As a result, the City’s net assets were reduced by approximately \$458 million net (reductions in net asset values totaled \$1.011 billion; they were offset by approximately \$533 million worth of additions.”**

**October 16, 2006** –At the meeting of the City Council, the 2003 Unaudited Draft CAFR is returned to the Mayor with no council action.

**January 1, 2007** - City of San Diego Second Annual Report on Internal Controls is issued by The Office of the Auditor & Comptroller, John Torell, CPA.

**January 25, 2007** – Independent Budget Analyst Report Number 07-18 issued for City Council Docket of January 29, 2007, Docket Item Number 201- Review of Second Annual Report of Internal Controls. The IBA’s Report focuses “on internal financial controls and does not endeavor to review disclosure procedures/controls which are separately addressed in Ordinance 19320.”

The IBA Report also notes that they reviewed two versions of the Internal Controls Report and that in comparing the final version to the substantially complete version they **“noticed the wording of a critical conclusion in the Executive Summary had been substantially modified. Specifically, the first paragraph under the heading Conclusions in the Executive Summary of the substantially complete report...”** had been changed from

“ ....we conclude that the City’s internal controls over financial reporting, as of this report date, **are minimally adequate to assure** timely and accurate preparation of the City’s annual financial statements.”

to

“The City’s internal controls over financial reporting, as of this report date, **have improved to permit** timely and accurate preparation of the City’s annual financial statements.”

**January 29, 2007** – Item Number 200 on City Council docket is the review and approval of the Second Annual Report on Internal Controls. City Council action is to adopt Resolution R- 302316.

**February 28, 2007** – Councilmember Frye learns from Jay Goldstone during a budget committee meeting that the internal audit department of the city has been re-assigned for the past year so they could get the financial reports issued.

**March 8, 2007** – Frye sends memo to City Attorney about audit function.

**March 12, 2007** – The 2003 CAFR Certification letter is signed by Greg Levin and Jay Goldstone. This is the letter included in the spiral bound, hard copy of the 2003 CAFR provided to the City Council.

**March 12, 2007** – KPMG issued, but did not release, two *Independent Auditors' Reports*, both dated March 12, 2007 on the City's 2003 financial statements. Both are two pages in length. One was issued in accordance with *Government Auditing Standards* and includes a reference on the second page to KPMG's Independent Auditors' Report on Internal Controls Over Financial Reporting and on Compliance and Other Matters based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*.

**Note:** For future reference of the above-mentioned documents;

- Independent Auditors' Report *will be referred to as **Opinion Letter***

- KPMG's Independent Auditors' Report on Internal Controls Over Financial Reporting and on Compliance and Other Matters based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards* will be referred to as **Internal Control Report**.

**March 14, 2007** – IBA issues Report on Internal Audit Division.

**March 16, 2007** –KPMG e-mails two **Opinion Letters**, dated March 12, 2007, to Jay Goldstone and Greg Levin. Both are two pages in length and one references the KPMG **Internal Control Report**.

**March 16, 2007** – Mayor Jerry Sanders holds a press conference to announce the receipt of the “clean” KPMG **Opinion Letter**.

The Mayor states in the Fact Sheet from the press conference that, “**The City had very poor internal controls which resulted in over 66 restatements worth approximately \$1 billion in absolute value. Those internal control problems are the subject of the various remediation measures launched by the Mayor.**”

**March 16, 2007** – KPMG's **Opinion Letter** and 2003 CAFR is posted on Mayor Sanders' website.

**Note:** In the hard copy of the 2003 CAFR provided to me, it states in the Letter of Transmittal on page 20 that, **"The City has identified the need to re-perform its Single Audit for fiscal year 2003. To accomplish this, the City has engaged the firm Macias Gini & O'Connell LLP to perform the audit."**

It also states that, **"As reported in the Auditor and Comptroller's Annual Report on Internal Controls, presented to the City Council in January 2006, the City's internal control framework requires significant improvements in order to produce timely and accurate financial statements in a cost effective manner. The internal control weaknesses identified in that report were a primary contributor to the need for restated fiscal year 2002 ending balances. These conclusions are supported by the findings and recommendations on the internal control structure and compliance with applicable laws and regulations provided by the City's independent auditors."**

**Note:** The above language is the same as the wording in the Letter of Transmittal in the 2003 Unaudited Draft CAFR provided by the Mayor to the City Council on October 2, 2006.

**March 16, 2007** – Meeting of SDCERS Board regarding Retirement Administrator Response to KPMG's request for signature of Audit Representation Letter in connection with the City's 2003 CAFR.

**March 19, 2007** – Meeting of the City Council Audit Committee. Item Number 1 is an update from KPMG of the 2003 CAFR.

**March 19, 2007** – Councilmember Frye requests from KPMG but does not receive a copy of KPMG's **Internal Control Report** dated March 12, 2007.

**March 22, 2007** –KPMG e-mails their **Internal Control Report** to Jay Goldstone and Greg Levin.

**April 18, 2007** – At a meeting of the Budget Committee, Councilmember Frye requests from Jay Goldstone and Greg Levin a copy of the KPMG **Internal Control Report**.

**April 18, 2007** – Greg Levin e-mails a copy of KPMG's **Internal Control Report** to Councilmember Frye. Levin's e-mail to Frye says, "Here you go."

**April 18, 2007** – Jay Goldstone and Greg Levin issue Report No. 07-065 to the City Council regarding the 2003 CAFR, which is on the City Council docket for April 23, 2007. The **Internal Control Report** from KPMG is not included, nor referenced.

Their report requests the following action from the city council: **"Receive and file"** the City's 2003 CAFR. This report includes an attachment, which is a certification of the

DPWG regarding the March 13, 2007 FY 2003 CAFR. The certification is signed by Mark Blake and includes the conditions under which the 2003 CAFR will be released to the public:

- (1) KPMG has issued their signed audit opinion letter regarding the financial statements,
- (2) The written certification required by Section 22.4111(b) of the Municipal Code is executed and
- (3) Council has **received and accepted** the FY 2003 CAFR. The certification also states that the FY 2003 CAFR, when released in its final form, will be accompanied by a certificate of the CFO and Auditor and Comptroller to the effect that, to the best of their knowledge, the information contained in the FY 2003 CAFR fairly presents, in all material respects, the financial condition and results of operation of the City as of, and for, the periods presented in the 2003 CAFR.

**April 19, 2007-** Councilmember Frye sends memo to the City Council, and cc's the City Attorney and IBA. The memo includes a copy of KPMG's **Internal Control Report**.

**April 19, 2007-** KPMG e-mailed to the Audit Committee members, Jay Goldstone and Greg Levin their letter dated March 23, 2007, which contains KPMG's communication with the Audit Committee relating to the conduct of the audit as required by professional standards (**SAS 61 Letter**)

**April 20, 2007** – Article by Matt Hall in *The San Diego Union-Tribune* on the KPMG **Internal Control Report** that is referenced in KPMG's **Opinion Letter**. Hall's article says that, **"A new assessment of San Diego's internal checks against fraud and error-filled financial statements shows management breakdowns are more widespread than previously stated by city officials and outside consultants."**

**April 20, 2007** – Greg Levin sends an e-mail to the City Councilmembers, addressed to the members of the Audit Committee that includes three attachments;

- First attachment is a memo to the City Council about Frye releasing KPMG's **Internal Control Report** that is referenced in KPMG's **Opinion Letter** issued March 12, 2007 and released March 16, 2007.
- Second attachment is the final KPMG **Internal Control Report** dated March 12, 2007 and released March 22, 2007, and
- Third attachment is KPMG's final SAS 61 Letter, dated March 23, 2007 (**Note:** The SAS 61 Letter includes the fact that there were 17 key drafts of the 2003 CAFR, including six since December 1, 2006. On October 2, 2006 the City Council received a copy of the eighth unaudited draft and was asked by Mayor Sanders to "approve" it on October 16, 2006.)



**April 22, 2007** – Mayor Jerry Sanders’ letter to the editor appears in *The San Diego Union-Tribune*. It states in part that, **“The City’s financial systems were so bad that it had to restate 66 items worth about \$2 billion as part of the 2003 audit.”**

**April 23, 2007** – Councilmember Frye issues memo regarding KPMG’s **Internal Control Report** to Greg Levin in response to his April 20, 2007 memo.

**April 23, 2007** - Item 202 on City Council docket is the City Auditor and Comptroller recommendation for the council to **“receive and file”** the FY 2003 CAFR and direct the city attorney to prepare the appropriate resolution in accordance with Charter Section 40. The item is continued to May 7, 2007.

**Note:** The proposed April 23 city council action to **“receive and file”** is not the same as the language in the DPWG certification language – that is, for the City Council to **“receive and accept.”** (See entry for April 18, 2007 for reference.)

**April 26 and 27, 2006** – Councilmember Frye requests from KPMG, clarification of actual release dates of KPMG’s **Opinion Letter** and KPMG’s **Internal Control Report**. Mr. DeVetter clarifies that KPMG issued two **Opinion Letters** both dated March 12, 2007 on the City’s 2003 financial statements. Both are two pages in length. One **Opinion Letter** was issued in accordance with *Government Auditing Standards* and includes a reference on the second page to KPMG’s **Internal Control Report**.

The **Internal Control Report** was also dated March 12, 2007, as that was the date of substantial completion of KPMG’s fieldwork. The report was released to Jay Goldstone and Greg Levin on March 22, 2007.

**April 26? 2007** – Report to the City Council (Number 07-082) issued by Greg Levin and Jay Goldstone on FY 2003 CAFR. (This Report is dated March 26, 2007 but it appears it should be dated April 26, 2007 instead.)

**April 30, 2007** – Meeting of City Council Audit Committee. Items for discussion include KPMG’s **Internal Control Report**.

Cc: IBA, Andrea Tevlin  
Mr. Stanley Keller  
KPMG